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## Cooperatives and the Domestic Production Deduction

-by Neil E. Harl\*

Cooperatives have enjoyed special treatment under the legislation enacted in 2004<sup>1</sup> which established the domestic production deduction<sup>2</sup> to replace the provisions in the Extra-Territorial Income Exclusion Act of 2000.<sup>3</sup> The World Trade Organization had ruled, on January 14, 2002, that the 2000 legislation was “inconsistent with international trade agreements” and had proceeded to press for an amendment or repeal of the 2000 law.<sup>4</sup> The 2004 Act repealed the offensive provisions but provided for a phase-out of the benefits that ran through 2006. Questions have been raised as to whether other firms, in competition with cooperatives, can qualify for the benefits available to cooperatives under the 2004 Act.<sup>5</sup>

### The Domestic Production Deduction

As is widely known, the domestic production deduction phased in over a four year period and has been nine percent of the lesser of the “qualified production activities income” of the taxpayer for the taxable year or the taxable income for the year.<sup>6</sup> The percentage was three percent for 2005 and 2006, six percent for 2007, 2008 and 2009 and nine percent since 2009.<sup>7</sup> The deduction cannot exceed 50 percent of the W-2 wages of the taxpayer for the taxable year that are allocable to domestic production gross receipts.<sup>8</sup> The term “wages” is defined as in I.R.C. § 3401(a) which does not include any remuneration other than cash, for agricultural labor.<sup>9</sup>

### The deduction is available to cooperatives

The deduction under the domestic production activities provision is allowed to cooperatives<sup>10</sup> with taxable income computed without regard to deductions allowed for patronage dividends, per-unit retain allocations and non-patronage distributions.<sup>11</sup> The regulations clarify that a cooperative may, at its discretion, pass through some, all or none of the allowable deduction to its patrons.<sup>12</sup> In order for a patron to qualify for the deduction, the cooperative must designate the patron’s portion of the deduction in a written notice mailed by the cooperative to its patrons not later than the 15th day of the ninth month following the close of the cooperative’s taxable year.<sup>13</sup>

### How is a “cooperative” defined?

The statute refers not just to “cooperative” but to a “specified agricultural or horticultural cooperative.”<sup>14</sup> The very same reference appears also in five other places in the statute.<sup>15</sup>

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The statute proceeds to define the term “specified agricultural or horticultural cooperative” to mean an organization to which Part I of Subchapter T of the Internal Revenue Code applies.<sup>16</sup> The relevant part of Subchapter T<sup>17</sup> states “This Part shall apply to (1) any organization exempt from tax under section 521 (relating to exemption of farmers’ cooperatives from tax), and (2) any corporation operating on a cooperative basis. . . “ with stated exceptions.<sup>18</sup>

#### In conclusion

Therefore, non-cooperative organizations, privately-held, are not eligible for the domestic production deduction under the provisions of I.R.C. § 199(d)(3) which authorize the deduction for “agricultural and horticultural cooperatives.” Moreover, the statute further requires “specified agricultural or horticultural cooperative” to be engaged “. . . (i) in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or (ii) in the marketing of agricultural or horticultural products.”<sup>19</sup> That seemingly rules out even agricultural or horticultural cooperatives operating outside that definition.

#### ENDNOTES

<sup>1</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004). See generally 4 Harl, *Agricultural Law* § 28.06[21] (2013); Harl, *Agricultural Law Manual* § 4.03[16] (2013); 1 Harl, *Farm Income Tax Manual* § 3.27 (2013 ed.). See also Harl, “Guidance on New Domestic Production Deduction,” 16 *Agric. L. Dig.* 25 (2005).

<sup>2</sup> I.R.C. § 199.

<sup>3</sup> Pub. L. No. 106-159, 114 Stat. 2423 (2000).

<sup>4</sup> “Tax Treatment of ‘Foreign Sales Corporations,’ Recourse to Article 21.5 of the DSU by the European Communities: Report of the Appellate Body,” January 14, 2002.

<sup>5</sup> I.R.C. § 199(d)(3).

<sup>6</sup> I.R.C. § 199(a).

<sup>7</sup> I.R.C. § 199(a)(2).

<sup>8</sup> I.R.C. § 199(b). See Treas. Reg. § 1.199-1(a).

<sup>9</sup> I.R.C. §§ 3401(a), 3121(a)(8)(A).

<sup>10</sup> I.R.C. § 199(d)(3).

<sup>11</sup> I.R.C. § 199(d)(3)(c). See, e.g., Ltr. Rul. 201250009, September 11, 2012 (per-unit retain allocations were paid in money; deduction could be computed without regard to grain payments).

<sup>12</sup> Treas. Reg. § 1.199-6(d).

<sup>13</sup> Treas. Reg. § 1.199-6(d). See I.R.C. § 199(d)(3)(A).

<sup>14</sup> I.R.C. § 199(d)(3)(A).

<sup>15</sup> I.R.C. §§ 199(d)(3)(B), 199(d)(3)(C), 199(d)(3)(D), 199(d)(3)(E)(ii), 199(d)(3)(E)(iii).

<sup>16</sup> I.R.C. § 199(d)(3)(F).

<sup>17</sup> I.R.C. § 1381(a).

<sup>18</sup> I.R.C. § 1381(a)(2) states – “any corporation operating on a cooperative basis other than an organization- (A) which is exempt from tax under this chapter, (B) which is subject to the provisions of –(i) part II of subchapter H (relating to mutual savings banks, etc., or (ii) subchapter I (relating to insurance companies), or (C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.”

<sup>19</sup> I.R.C. § 199(d)(3)(F).

## AGRICULTURAL TAX SEMINARS

by Neil E. Harl

On the back cover, we list the agricultural tax seminars coming up in the spring of 2013. Here are the dates and cities for the seminars later this summer and fall 2013:

August 28-29, 2013 - Ames, IA

September 9-10, 2013 - Honey Creek Resort, Moravia, IA

September 16-17, 2013 - Moorhead, MN

September 19-20, 2013 - Sioux Falls, SD

October 3-4, 2013 - Council Bluffs, IA

October 10-11, 2013 - Bettendorf, IA

November 7-8, 2013 - Indianapolis, IN

November 14-15, 2013 - Illinois

November 18-19, 2013 - Mason City, IA

More information will be posted on [www.agrilawpress.com](http://www.agrilawpress.com) and in future issues of the *Digest*.

## FARM ESTATE AND BUSINESS PLANNING

by Neil E. Harl

The Agricultural Law Press is honored to publish the revised 16th Edition of Dr. Neil E. Harl’s excellent guide for farmers and ranchers who want to make the most of the state and federal income and estate tax laws to assure the least expensive and most efficient transfer of their estates to their children and heirs.

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